APPENDIX

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
DECEMBER 20-21, 1982

Desk operations since the last meeting were undertaken against a background of fairly close-to-path performance for the broad monetary aggregates that have been the main focus of policy. The narrow money supply continued to grow strongly, and this was essentially accommodated by Desk operations, in line with Committee instructions. Punctuated by two cuts of 1/2 percentage point in the discount rate, most short-term interest rates declined somewhat, in most cases by about 1/2 percentage point. Most longer-term rates, in contrast, were unchanged to slightly higher over the interval as the market faced heavy current and prospective supplies and some market participants expressed concern about the implications of recent developments for future inflation.

Early in the period, when estimates of M2 growth were slightly ahead of path and generating reserve demands also a little above path, the Desk was aiming for nonborrowed reserve levels consistent with borrowing in the $300 million area, compared to the initial assumption of $250 million. Later, as M2 was seen to be just about on or even a little below path, the intended borrowing gap narrowed, to around $230 million in the latter weeks of the interval. Actual borrowing levels occasionally exceeded intentions by a fair margin, however, reflecting some overestimates of reserve availability, and underestimates of demand for excess reserves.

The Federal funds rate, which had run quite close to the 9 1/2 per cent discount rate from mid-October through mid-November, moved down just about coincidentally with the November 19 posting of a 9 per cent discount rate to vary just slightly below that new discount rate level. The weekly averages were in a range of about 8.70 to 8.90 per cent. The further reduction in the discount rate to 8 1/2 per cent announced last Monday, December 13, was not accompanied quite so soon by a decline in the funds rate, probably because of lingering effects of reserve scarcities carried over from last Wednesday when a shortfall in reserve availability and unexpectedly high demand for excess reserves caused a large bulge in borrowing. These effects seemed to be abating by last Friday afternoon and today, as funds settled in to trade at 8 1/2 - 5/8 percent.

The meeting of seasonal reserve needs, especially currency outflows, and the accommodation of strong M1 growth, called for large reserve injections in the recent period. The System's outright holdings of bills were increased by about \$2.7 billion including \$1.1 billion bought from the market and \$1.6 billion from foreign accounts. This nearly used up the \$3 billion leeway for intermeeting changes in outright holdings. The System also took delivery of \$900 million of coupon issues, bought the day of the last meeting, which counted against the temporarily enlarged leeway of the previous period. Repurchase agreements, either for the System or customers, were used on a number of occasions to augment reserves temporarily, while matched sales were employed once in the market as well as each day with foreign customer accounts. Seasonal forces will reverse ground soon after the turn of the year, releasing a large volume of reserves that we will want to absorb.

Interest rates registered mixed changes over the inter-meeting period, ranging from moderate declines at the short end--not fully matching the 1 per cent decrease in the discount rate--to small increases for some longer term issues. Aided by a lower Federal funds rate and some decline in day-to-day financing costs, bill rates were down roughly 50 basis points over the period. Today, 3 and 6-month issues were auctioned at around 7.85 and 8.10 per cent, respectively compared with 8.45 and 8.54 per cent just before the last meeting. It may be noted, though, that the mid-November bill rates were about a half percentage point or so higher than in mid-October. The Treasury continued to borrow heavily in the bill market since the last meeting, raising about $15 billion in that sector. Other short rates such as those on commerical paper and bank CDs came down, net, about as much as bills. Supplies of private paper were more limited than bills, with some periods of actual shrinkage in commercial paper and CDs. Major commercial bank prime rates were reduced just 1/2 percentage point, early in the interval to 11 1/2 per cent. Bank payments of temporarily above-market rates on new money market accounts may be a factor tending to hold up the prime rate for the time being.

There was a different story in the longer-term market, where rates were little changed or even slightly higher on balance over the period. The continued evidence of a weak economy provided support to the market, but present and prospective supplies of new issues were huge, and there was some concern that official encouragement of lower rates and complacency regarding strong money growth might be overdone. Including issues still to be paid for, the Treasury raised about $13 billion through coupon offerings during the period: adding the 7 and 20-year issues to be sold tomorrow and Wednesday, that figure would be over $20 billion. Not long ago, that would have been a year's worth of additions to the coupon market. For Treasury issues in the 3-10 year range, most yields were about unchanged to down 20 basis points over the period. For issues over 10 years, most yields were up 20 to 30 basis points.

Corporate yields moved a little higher over the period while the volume tapered off from the exceptionally high October level. In the tax-exempt market, yields also worked higher for long-term issues while a record volume came to market in November. December volume has abated somewhat, but is still relatively high for the month as issuers have sought to come to market before the turn of the year. Legislation now on the books would rule out issuance of bearer securities after year-end, although a last minute effort is being made to delay the deadline.

Reference was made earlier to the likelihood of having to undertake large reserve absorptions in the next several weeks. On present projections, the amount could run between \$3 and \$4 billion. In light of this, I recommend that the Committee temporarily enlarge to \$4 billion the standard leeway in the authorization for domestic open market operations.

James L. Kichline
December 20, 1982

FOMC BRIEFING

Since the last meeting of the Committee signs of weakness in aggregate economic activity have persisted. The staff is now forecasting a decline in real GNP this quarter of 1½ to 2 percent at an annual rate. But the drop reflects a resumption of inventory liquidation, as final demands have firmed a bit. Overall, the available information on the economy gives a greater sense than a month or two ago that the recession is drawing to a close and recovery is near at hand. Obviously, we have been disappointed in making a similar judgment earlier this year and one could conceive that this forecast may still be premature. Indeed, the economy remains quite sick and the basis for a sustained upturn is not yet assured given the mixed developments to date.

The labor market surveys for November indicate another sizable cutback in nonfarm employment -- about the same as the average monthly declines earlier this year -- and a rise in the unemployment rate to 10.8 percent. Job losses were concentrated in durable goods manufacturing, such as machinery and metals industries, where orders have been weak and inventories high. Initial claims for unemployment insurance were still high in the first week of December at around 600,000 per week, but they have edged down 100,000 from the peak rates in late September and early October. The information available on plant closings and production curtailments also points to a slackening in the pace of permanent job losses and temporary layoffs.

While industrial production fell again in November, the 0.4 percent decline in the index was half that in each of the preceding two months. Output of defense and space equipment continued to expand, while most other major sectors showed reductions in output. However, there were a few encouraging developments, including an upturn in oil and gas well drilling following the steep declines through much of this year. In addition, this month auto output is on the rise associated with the industry's success in reducing excess stocks through a combination of earlier cutbacks in production and sales incentive programs.

Auto sales in November in fact accounted for much of the more than 2 percent increase in total retail sales during that month. Auto sales early in December slipped below a 6 million unit rate, which was not unexpected given the usual pattern of weaker sales following strong sales incentive programs. Retail sales other than autos and nonconsumer items rose ½ percent in nominal terms in November, not an especially strong performance. Reports on sales in December, from the Redbook, the press, and directly from major retail chains, generally suggest sales were only fair in the first half of December amidst aggressive promotional activity. In the staff forecast we have assumed a small rise in sales similar to November and the reports to date appear consistent with that assumption. We also have assumed that pattern of sales will persist early in 1983, reflecting constraints on income growth.

In the housing sector, the recovery in activity is firmly established. Housing starts in November rose one-fourth to over a 1.4 million unit rate with both single and multifamily units contributing to the rise; permits also rose but by much less than starts. The November starts figures were higher than expected, and perhaps were affected by the unseasonably good weather. In any event, the housing sector on average is projected to continue providing support to activity overall.

In contrast, business fixed investment spending this quarter seems likely to show another sizable drop. Shipments and orders for capital goods remain weak, and other quantitative and qualitative evidence points to further, but smaller, declines in the first half of next year. The incoming evidence, however, seems roughly in line with our expectations at the last meeting of the Committee and, in contrast to other recent projections, we have not been inclined to make further appreciable downward revisions to the forecast.

Along with capital spending, the other major sectors currently exhibiting a drag on activity -- inventories and exports -- also seem to be going through the worst now and there is a reasonable basis for expecting smaller declines early next year. Together with some growth of consumer spending and further expansion in housing activity, this should lead to a return of real growth next quarter.

Both wages and prices have been behaving about as expected and that portion of the staff forecast is little changed. The wage sector in particular looks quite good, with the hourly earnings index this year likely to show a rise of a little under 6 percent, 2½ percentage points less than in 1981. Moreover, we are expecting productivity to expand around 2 percent this year and unit labor costs in 1982 should be in the neighborhood of 4-4½ percent -- less than half the rate of a year ago. On the price side there also has been a substantial improvement this year, although the latest monthly figures were a bit high, owing to temporary factors in measured energy prices. The forecast contains further reductions in inflation next year in an environment of a large degree of slack in labor and product markets.

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NOTES FOR FOMC MEETING
December 20, 1982

Sam Y. Cross

The dollar has reversed course in recent weeks and entered what many think might be an extended declining trend. Thus, while in early November the dollar had traded at 2.60 in terms of German marks, in December it was back down close to 2.40; in terms of yen, the dollar moved from a high of about 2.79 to a low of about 2.42. A major factor in the market's reappraisal has been a series of projections by U.S. officials (and by some foreign officials as well) pointing to a sharp deterioration in the U.S. trade and currency accounts next year. Whereas, previously, most market participants had felt that weak U.S. economic activity would limit the worsening in our trade balance, analysts are now looking for a move into deep deficit in the U.S. current account principally associated with eroding price competitiveness and even without much pick-up in U.S. domestic demand and output.

Expectations of lower U.S. interest rates have also played a role in the market's thinking. As you know, the most recent surprise cut in the discount rate on December 13 triggered a sharp sell-off of the dollar in the exchanges where it dropped 1-3/4 percent overnight against the German mark. Many in the market felt that a rapid decline in our interest rates would not be facilitated--and official projections of record U.S. trade deficits would not be made--unless the authorities were comfortable with a drop in dollar exchange rates. Still, there is considerable uncertainty about the future. One school of thought maintains that inflationary concerns will lead the Federal Reserve to tighten up, thereby pushing nominal (and real) U.S. interest rates higher and cushioning the dollar's decline. Another school feels the Federal Reserve can go considerably farther to encourage domestic recovery and would in any event not move to counter a rapid fall in the dollar.

Meanwhile, European officials, deeply concerned about the prospect of continued recession in 1983, have welcomed the reduction in U.S. interest rates, and in several centers abroad official lending rates were reduced on December 2. In other centers exchange rate pressures have constrained the authorities from lowering interest rates. This has been the case in the United Kingdom and in the weaker EMS currency countries such as France and Italy. In fact, tensions in the EMS joint float have heated up a great deal recently. Weaker European currencies have had difficulty keeping pace with the rise of the mark against the declining dollar, and market participants, seeing that large intervention has been needed to maintain the exchange rates, question whether existing parities will continue to be defended for long at that cost. Pressure on the French franc was particularly heavy before last weekend's meeting of EMS Finance Ministers.

Tentative and cautious optimism has developed in the market that international debt problems are being better dealt with. IMF adjustment programs, bridging finance by central and private bankers, and the growing resolve of countries like Brazil and Mexico to address their economic difficulties have all provided some reassurance to the market. One result has been a lessening of the demand for dollar liquidity which previously had been an important source of the dollar's strength in the exchanges.

Recently the dollar's decline has been cushioned by good corporate demand, in part related to year-end payment needs, and by professional short-covering in relatively thin end-of-year markets. In fact, the degree of support for the dollar that emerged at the lower levels was sufficiently impressive as to prompt some participants to scale back their earlier estimates of how rapidly dollar exchange rates would ease in the near term.

Since the last meeting of the Committee, the Bank of Mexico was granted drawings of $190 million on the combined U.S.-BIS credit facility, leaving $560 million still available as of close of business yesterday. Also, the Mexican authorities were granted three-month renewals of two earlier drawings totalling $117.2 million. In addition, it was announced that the U.S. Treasury has provided $1.23 billion of short-term financing to Brazil.

Mr. Chairman, six swap drawings, totalling $160.5 million, under the $325 million Federal Reserve special swap arrangement--extended as part of the $1.85 billion combined U.S.-BIS credit facility to Mexico--will mature between now and February 17, 1983. I recommend that these drawings, listed below, be extended for three more months. This will represent the first renewal of the drawings:

Line in continuous use since	Institution	Amount ($ millions)	Maturity	Current Term	Requires Amendment	May be made Public
9/7/82	Bank of Mexico	35.0 1st R.	1/7/83	3 mos.		N/A
	Bank of Mexico	24.0 1st R.	1/18/83	3 mos.		N/A
	Bank of Mexico	35.0 1st R.	1/25/83	3 mos.		N/A
	Bank of Mexico	17.5 1st R.	1/26/83	3 mos.		N/A
	Bank of Mexico	35.0 1st R.	1/27/83	3 mos.		N/A
	Bank of Mexico	14.0 1st R.	2/17/83	3 mos		N/A
	Total	$160.5				

In addition, the $700 million swap drawing under the regular Federal Reserve swap with the Banco de Mexico will fall due on February 4, 1983. We hope to have this amount repaid in whole or in part on the due date, but the Mexican situation is still very uncertain, and the likelihood of a need to request a further extension is substantial. I would propose that we be prepared to provide a further extension if needed, at the time.